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AZ CORP COMMISSION
SUIT CONTROL

BEFORE THE ARIZONA CORPORATION COMMISSION

IN THE MATTER OF THE FILING BY
TUCSON ELECTRIC POWER COMPANY
TO AMEND DECISION NO. 62103

DOCKET NO. E-01933A-05-0650

**NOTICE OF FILING BY PHELPS
DODGE MINING COMPANY AND
ARIZONANS FOR ELECTRIC
CHOICE AND COMPETITION OF
SUMMARY OF AND
SURREBUTTAL TESTIMONY
OF KEVIN C. HIGGINS**

Phelps Dodge Mining Company and Arizonans for Electric Choice and
Competition (collectively "AECC"), hereby submits its Summary of and Surrebuttal
Testimony of Kevin C. Higgins in the above captioned Docket.

RESPECTFULLY SUBMITTED this 8th day of February 2007.

FENNEMORE CRAIG, P.C.

By: 

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Arizona Corporation Commission

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9 Lyn A. Farmer
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11 Hearing Division
12 Arizona Corporation Commission
13 1200 West Washington
14 Phoenix, AZ 85007

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16 this 8th day of February 2007 to:

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1 My surrebuttal testimony responds to the assertions put forth by TEP in the
2 rebuttal testimony of James S. Pignatelli with respect to: (1) the company's
3 generation assets, and how they are somehow unregulated at this time; and (2) the
4 continued mischaracterization of TEP's standard offer rates, and the purpose of its
5 various components such as the CTC, MGC and Adder.

6
7 TEP's generation assets are regulated -- either by the Arizona Corporation
8 Commission ("ACC") or the Federal Energy Regulatory Commission ("FERC").
9 It is clear from the Track A Decision that the ACC declined to transfer its
10 ratemaking jurisdiction over generation assets to FERC.

11
12 Furthermore, while TEP's claim that it can sell all power from its generating
13 assets into the wholesale market, as well as purchase all the power its needs for
14 Standard Offer service from the wholesale market, may be a physical reality, the
15 economic reality is a rate making determination by the ACC of whether such
16 transactions are prudent. And, while divestiture may not be a precondition for
17 TEP selling all of its generation on the market, it is a precondition for the transfer
18 of jurisdiction over TEP's generation assets from the ACC to FERC.

19
20 Contrary to Mr. Pignatelli's assertions, I certainly do not acknowledge that TEP is
21 currently charging market-based rates. The arguments presented in his rebuttal
22 testimony concerning the MGC are nowhere to be found in the 1999 Settlement
23 Agreement or ACC Decision approving it. The MGC was not of "secondary
24 importance" to its role as an observable pricing mechanism. One only has to read
25 the Settlement Agreement to see that the Floating CTC only exists as a means of
26 collecting stranded costs, and that the MGC is introduced expressly for the
27 purpose of calculating the Floating CTC. Absent the choice to collect stranded
28 costs using a floating charge, the MGC would not exist.

29
30 Mr. Pignatelli's attempt to rearrange an equation I presented in my Direct
31 Testimony to support TEP's claim that the market rate for Standard Offer
32 generation will equal the MGC, plus Adders once the CTCs expire, is
33 meaningless. When stranded costs are no longer being recovered, the CTCs,
34 MGC and Adders no longer have any role, and are not given any further role in
35 the Settlement Agreement.

36
37 Finally, I illustrate how TEP is incorrect by asserting that the Floating CTC will
38 increase by the same amount when the Fixed CTC is terminated. I refer to both
39 language in the Settlement Agreement, as well as my direct testimony filed in
40 1999 in support of the TEP Settlement Agreement -- testimony what went
41 unchallenged during the proceedings. It is clear TEP's claims are completely
42 unsupported by the record in the 1999 proceeding, and the parties' intentions with
43 respect to the CTC.

1 **BEFORE THE ARIZONA CORPORATION COMMISSION**

2
3 IN THE MATTER OF THE FILING BY)
4 TUCSON ELECTRIC POWER COMPANY) Docket No. E-01933A-05-0650
5 TO AMEND DECISION NO. 62103)
6

7
8
9 **Surrebuttal Testimony of Kevin C. Higgins**

10
11 **on behalf of**

12 **Phelps Dodge Mining Company and**

13 **Arizonans for Electric Choice and Competition**
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20

21 **February 8, 2007**

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1 **SURREBUTTAL TESTIMONY OF KEVIN C. HIGGINS**

2

3 **I. Introduction**

4 **Q. Please state your name and business address.**

5 A. Kevin C. Higgins, 215 South State Street, Suite 200, Salt Lake City, Utah,
6 84111.

7 **Q. By whom are you employed and in what capacity?**

8 A. I am a Principal in the firm of Energy Strategies, LLC. Energy Strategies
9 is a private consulting firm specializing in economic and policy analysis
10 applicable to energy production, transportation, and consumption.

11 **Q. On whose behalf are you testifying in this proceeding?**

12 A. My testimony is being sponsored by Phelps Dodge Mining Company
13 ("Phelps Dodge") and Arizonans for Electric Choice and Competition ("AECC"),
14 (collectively "AECC").

15 **Q. Are you the same Kevin C. Higgins who previously filed direct testimony in**
16 **this proceeding?**

17 A. Yes, I am.

18 **Q. What is the purpose of your surrebuttal testimony?**

19 A. My surrebuttal testimony responds to a number of the statements in the
20 rebuttal testimony filed by TEP witness James S. Pignatelli.

21 **Q. Do you respond to each and every instance in which you disagree with Mr.**
22 **Pignatelli's characterization of provisions in the Settlement Agreement or**
23 **with his position with respect to your direct testimony?**

1 A. No. I have already addressed most of these issues in my direct testimony,
2 and I have no changes or corrections to make to that testimony. I will limit myself
3 here to responding to statements in Mr. Pignatelli's rebuttal testimony that were
4 not covered in my direct testimony or which may warrant additional discussion.

5

6 **Surrebuttal of Mr. Pignatelli**

7 **Q. On page 6 of his rebuttal testimony, Mr. Pignatelli states that AECC's**
8 **arguments concerning the ratemaking implications of the cancellation of**
9 **TEP's divestiture are "unsupportable because TEP's generation assets are**
10 **unregulated now." What is your response?**

11 A. I don't quite understand Mr. Pignatelli's claim that TEP's generation
12 assets are "unregulated." I am not an attorney, but it is my understanding that
13 investor-owned generation facilities in Arizona are either regulated by the Federal
14 Energy Regulatory Commission ("FERC") or by this Commission, depending on
15 whether the transactions under consideration are deemed to be wholesale or retail.
16 Even market-based wholesale transactions occur under the auspices of FERC
17 jurisdiction. Moreover, Mr. Pignatelli's assertion appears very much at odds with
18 the following statement by the Commission in the Track A Decision:

19 "In actuality, no retail competition exists; market power is held by the
20 incumbent utilities; no RTO is in effect; transmission constraints exists
21 that potentially exacerbate market abuse; the GAO has issued a negative
22 report on FERC's ability to manage competitive markets; both TEP and
23 APS recognize a problem – one wants to postpone its divestiture while the
24 other is affected by its parent's and affiliates' adverse financial
25 considerations; proposed new generation may be cancelled if it is not able
26 to find a market; more protections are needed against self-dealing and
27 inappropriate affiliate transactions; and investigations are ongoing into
28 market manipulations and improprieties. Contrary to what APS argues,

1 these changes relate to the question of divestiture, *especially to our*
2 *willingness to transfer our ratemaking jurisdiction over generation assets*
3 *to FERC*, given its recent history regulating the wholesale market and
4 conclusions contained in the recent GAO report.” [Emphasis added]
5

6 The italicized passage in the excerpt above seems to indicate that the
7 Commission does not share Mr. Pignatelli’s view with respect to whether TEP’s
8 generation assets are unregulated. It appears that the Commission believes that
9 these assets remain under its jurisdiction.

10 **Q. In support of his assertion that TEP’s generating assets are “unregulated”**
11 **today, Mr. Pignatelli states on page 6 of his rebuttal testimony that “TEP**
12 **could sell all of its power from its generating assets into the wholesale market**
13 **and purchase all of the power it needs to provide Standard Offer service**
14 **from the wholesale market today.” Mr. Pignatelli reiterates this assertion on**
15 **page 38. Do you wish to comment on this statement?**

16 **A.** Yes. This hypothetical scenario could be applied to just about any utility
17 in the United States; it does not follow that executing this approach would mean
18 that the utility’s generating assets were unregulated. In such a scenario, the
19 question that the utility’s state regulators would address for the purpose of retail
20 ratemaking is whether the utility’s actions in implementing such a sell/buy
21 strategy were prudent.

22 Mr. Pignatelli also states on page 5 that “divestiture is not a precondition
23 to competition or to TEP selling all of its generation on the market.” I agree that
24 divestiture is not a precondition for TEP selling all of its generation on the market
25 – rather it is a precondition for transfer of jurisdiction over TEP’s generating

1 assets from this Commission to FERC. By cancelling divestiture and retaining
2 jurisdiction, the Commission remains in a position to judge whether actions taken
3 by TEP with respect to its generating assets are prudent; the Commission can also
4 determine whether rates for Standard Offer generation service are just and
5 reasonable without the restrictions that would be imposed by loss of jurisdiction.
6 In downplaying the significance of the Track A Decision, Mr. Pignatelli appears
7 to overlook these implications.

8 Mr. Pignatelli also appears to overlook the fact that TEP is not the first
9 Arizona utility for which the implications of the Track A Decision have been
10 addressed. APS' divestiture plans were also cancelled by the Track A Decision
11 and there is no debate about whether the Commission views APS' Standard Offer
12 generation service as being priced at cost-of-service: it most decidedly does.

13 **Q. On page 9 of his rebuttal testimony, Mr. Pignatelli states that all parties**
14 **acknowledge that TEP is currently charging market-based rates for**
15 **generation service with an adjustment during the transition period to**
16 **accommodate the rate freeze required by the 1999 Settlement Agreement. Do**
17 **you wish to respond to this statement?**

18 A. I have made no such acknowledgement. I disagree with Mr. Pignatelli's
19 characterization of TEP's standard offer generation rates, which I explained in my
20 direct testimony at p. 19, line 18 through p. 20, lines 3; and further at p. 22, line
21 11 through p. 24, line 13. I offer these brief excerpts from my direct testimony:

22 As "current bundled rates" are the product of regulation, the standard offer
23 generation component contained within this capped bundled rate is a
24 regulated rate as well, contrary to TEP's claim that even *current* Standard
25 Offer generation rates are somehow determined by the MGC. [pp.19-20]

1
2 TEP's Standard Offer generation rates were derived from the Company's
3 regulated bundled rates that were in effect at the time of the Settlement
4 Agreement. This rate is not based on market prices, but is an unchanging,
5 cost-based price. [p. 23]
6

7 **Q. Starting on page 38, line 21 and continuing to the bottom of page 39 of his**
8 **rebuttal testimony, Mr. Pignatelli presents arguments as to why he believes**
9 **the MGC complies with the requirement in the Electric Competition Rules**
10 **that Standard Offer generation service must be provided at "regulated, cost-**
11 **based rates." Do you wish to comment on Mr. Pignatelli's rebuttal testimony**
12 **on this topic?**

13 **A.** Yes. It is important to recognize that the arguments presented by Mr.
14 Pignatelli on pages 38-39 of his rebuttal testimony concerning the MGC are
15 nowhere to be found in the Settlement Agreement or in the Commission Decision
16 approving it. Mr. Pignatelli's arguments on these pages do not provide any
17 support for TEP's primary claim that the Settlement Agreement *requires* the use
18 of the MGC to set Standard Offer generation rates after January 1, 2009.

19 **Q. On page 45 of his rebuttal testimony, Mr. Pignatelli states that "at the time**
20 **the Settlement Agreement was being negotiated, the use of the MGC to**
21 **calculate the Floating CTC was clearly of secondary importance" to its role**
22 **as "an observable pricing mechanism." Do you agree with the statement?**

23 **A.** As I made clear in my direct testimony, I do not agree at all with this
24 claim. One only has to read the Settlement Agreement itself to see that the
25 Floating CTC only exists as a means of collecting stranded cost and that the MGC
26 is introduced expressly for the purpose of calculating the Floating CTC. Any role

1 the MGC has as an “observable pricing mechanism” during the transition period
2 is unique to the design of TEP’s stranded cost recovery mechanism. If it were not
3 for the choice to collect stranded cost using a *floating* charge, the MGC would not
4 exist in the first instance. A case in point: APS’ stranded cost recovery was
5 implemented without a floating charge. Its stranded cost recovery occurred
6 through a series of fixed charges that declined each year. Consequently, there was
7 no MGC in the APS transition plan, as without a floating stranded cost charge
8 there is no need for an MGC.

9 **Q. On page 47 of his rebuttal testimony Mr. Pignatelli rearranges an equation**
10 **you presented in your direct testimony and he cites this rearranged equation**
11 **as support for TEP’s claim that the market rate for Standard Offer**
12 **generation will equal the MGC plus Adders once the CTCs expire. Do you**
13 **wish to comment?**

14 A. Yes. On pages 20-22 of my direct testimony I explained the conceptual
15 structure underlying TEP’s stranded cost recovery, and presented the following
16 equation:

17
$$\text{Fixed CTC} + \text{Floating CTC} = \text{Standard Offer Generation Rate} - (\text{MGC} + \text{Adder}).$$

18 This equation answers the question: How is TEP’s stranded cost
19 determined? It shows that TEP’s stranded cost recovery is equal to the amount by
20 which TEP’s cost of providing Standard Offer generation service exceeds the
21 market price of generation (for retail delivery). When stranded cost is no longer
22 being recovered, the equation has no meaning. When stranded cost is no longer
23 being recovered, the CTCs, the MGC, and the Adder no longer have any role –

1 they are certainly not given any further role in the Settlement Agreement. In the
2 context of the Settlement Agreement, Mr. Pignatelli's rearrangement of the terms
3 in the equation has no meaning after December 31, 2008.

4 **Q. On page 48 of his rebuttal testimony Mr. Pignatelli takes issue with your**
5 **statement that the Standard Offer generation rate will decrease by the**
6 **amount of the Fixed CTC once it expires. Do you wish to comment?**

7 A. Yes. Mr. Pignatelli is incorrect when he claims that when the Fixed CTC
8 is terminated the Floating CTC will be increased by the same amount. Section
9 2.1(b) of the Settlement Agreement states, in relevant part:

10 The Fixed CTC Component shall terminate when it has yielded a stranded
11 cost recovery of four hundred fifty million dollars (\$450 million), or on
12 December 31 2008, whichever occurs first. *When the Fixed CTC*
13 *terminates, unbundled service rates will be reduced by the same amount.*
14 [Emphasis added].
15

16 The italicized sentence makes it clear that TEP's rates are supposed to be
17 reduced by the amount of the Fixed CTC when the latter terminates. Otherwise,
18 there would have been little point in requiring that the Fixed CTC be terminated if
19 \$450 million is collected prior to December 31, 2008. This provision is expressly
20 noted in Decision No. 62103 on page 5, lines 24-26,¹ and again in Finding of Fact
21 27. As Standard Offer rates are the sum of the unbundled rates, this language was
22 intended to ensure that the rate reduction from the termination of the Fixed CTC
23 would be experienced by both Standard Offer and Direct Access customers. I note
24 here that the Floating CTC is part of unbundled rates, so the device described by
25 Mr. Pignatelli whereby the Floating CTC would automatically increase to wipe

¹ "The Fixed CTC will terminate after \$450 million has been collected or on December 31 2008, whichever occurs first. Upon termination, unbundled rates will be reduced by the 0.93 cents/kWh amount."

1 out the reduction in the Fixed CTC is expressly ruled out in the Settlement

2 Agreement and Decision No. 62103.

3 **Q. Can you provide additional information supporting your explanation?**

4 A. Yes. In 1999 I filed direct testimony in support of the TEP Settlement
5 Agreement. Part of my purpose was to ensure that the provisions of the Settlement
6 Agreement were clearly understood. On page 8 of my testimony I addressed the
7 expiration of the Fixed CTC and the implication for rates. That testimony reads as
8 follows:

9 Q. HOW DOES THE FIXED CTC WORK?

10
11 A. The Fixed CTC will be used to recover \$450 million (present
12 value) in stranded costs (Section 2.19(b)). The Fixed CTC will be
13 recovered from all kwh purchased off the grid – including Standard Offer
14 service, although there will not be an increase in rates as a result of this
15 recovery. When the \$450 million is recovered, the Fixed CTC will be
16 removed from rates. In no case will the Fixed CTC extend beyond
17 December 31, 2008.

18
19 Q. WHAT PROCEDURE WILL BE USED TO ENSURE THAT TEP
20 DOES NOT OVER-RECOVER THE FIXED CTC?

21
22 A. The actual payments of Fixed CTC will be tracked by TEP.
23 Section 5.2 provides that by June 1, 2004 TEP will file a report with the
24 Staff director identifying any required modifications to the Fixed CTC,
25 Floating CTC, distribution tariffs, and other unbundled components that
26 would have the effect of reducing standard offer rates and /or overall
27 unbundled rates (while providing for TEP's recovery of cost associated
28 with provider of last resort service in standard offer rates). This report
29 will include a specific recommendation as to whether the Fixed CTC can
30 be eliminated or otherwise reduced prior to December 31, 2008.

31
32 Q. WHEN THE FIXED CTC IS REMOVED FROM RATES WILL
33 THE FLOATING CTC BE INCREASED BY THIS AMOUNT?

34
35 A. No. Removing the Fixed CTC from rates means that it is truly
36 removed.
37

1 The final question and answer above make it clear that Mr. Pignatelli's
2 claim on this point is completely contrary to the record supporting the Settlement
3 Agreement. My testimony on this point was not challenged in any way by TEP
4 during the Settlement Agreement hearing – nor should it have been, as my
5 explanation was entirely consistent with the understanding of the parties.

6 **Q. Does this conclude your surrebuttal testimony?**

7 **A. Yes, it does.**